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Manhattan Appeals

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Chief, CC:INTL:Br2 - INTL-728-87

Interpretation of Section 1.954-2(d) of the Income Tax Regulations.

You have requested our assistance concerning the proper calculation of the amount excludable from foreign personal holding company income for insurance companies under former sections 954(c)(3)(B) and 954(c)(3)(C) of the Internal Revenue Code of 1954 and section 1.954-2(d) of the regulations. The years at issue are the taxpayer's [REDACTED] and [REDACTED] taxable years.

Under former section 954(c)(3)(B), foreign personal holding company income does not include dividends, interest and gains from the sale or exchange of stock or securities derived from the investments made by an insurance company of its unearned premiums or reserves ordinary and necessary for the proper conduct of its insurance business, and which are received from a person other than a related person. Section 1.954-2(d)(3)(iii) states that the maximum amount eligible for the exclusion under former section 954(c)(3)(B) is an amount equal to the eligible income (defined in section 1.954-2(d)(3)(iv)) multiplied by a fraction. The numerator of the fraction is the mean of the controlled foreign corporation's unearned premiums or reserves at the beginning and the end of its taxable year. The denominator of the fraction is the mean of the reserve assets held at the beginning and the end of its taxable year.

Former section 954(c)(3)(C) states, that foreign personal holding company income does not include dividends, interest, and gains from the sale or exchange of stock or securities received from persons other than related persons (within the meaning of section 954(d)(3)) derived from investments made by an insurance company of an amount of its assets equal to one-third of its premiums earned on insurance contracts during the taxable year (as defined in

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section 832(b)(4)) which are not directly or indirectly attributable to the insurance or reinsurance of risks of persons who are related persons. The maximum amount of the exclusion under former section 954(c)(3)(C) is determined in the same manner as described in section 1.954-2(d)(3)(iii) of the regulations with the exception that the numerator of the fraction described in that section is equal to one-third of earned premiums. Section 1.954-2(d)(4)(ii).

The first issue regards the denominator of the fraction. You have asked whether certain assets are included within the meaning of the term "reserve assets". These assets are furniture and office equipment, accounts receivable, deposits, and short and long term investments in various types of securities. Section 1.954-2(d)(3)(iii) of the regulations defines "reserve assets" as assets which may give rise to foreign personal holding company income described in section 954(c)(1) (without regard to the modifications and adjustments under section 954(c)(3) and (4)). Former section 954(c)(1) states, in relevant part, that the term "foreign personal holding company income" means foreign personal holding company income as defined in section 553. Section 553 states, in relevant part, that foreign personal holding company income means dividends, interest, royalties, annuities, and gains from the sale or exchange of stock or securities.

Furniture and office equipment should not be included in reserve assets. Such assets are not income producing assets and do not give rise to the type of income which section 553 treats as foreign personal holding company income. The accounts receivable should also be excluded from the computation of reserve assets. Because the receivables are for premiums due but not yet received and premiums would not give rise to foreign personal holding company income, the receivables are not reserve assets. Moreover, even if there should be an interest element on the receivables, they should still not be treated as reserve assets as long as the interest is incidental to the premiums. See, section 1.954-1(f)(2) of the regulations.

The short and long term investments in various types of securities are reserve assets since the dividend and interest income on the assets would be foreign personal holding company income. The deposits are also reserve assets assuming they give rise to interest income.

The second issue on which you requested guidance is whether the numerators of the fractions for computing income excludable from foreign personal holding company income under former sections 954(c)(3)(B) and 954(c)(3)(C) should be reduced by expenses such as commissions. We do not believe that the respective numerators should be reduced by expenses. Section

1.954-2(d)(3)(iii) of the regulations states that the amount of reserve assets attributable to real property and stock is determined on the basis of their fair market value and that other reserve assets are taken into account at their adjusted basis. It is apparent, then, that reserve assets are calculated on a gross basis. Moreover, with respect to former section 954(c)(3)(C), the definition of earned premiums is governed by section 832(b)(4). Section 832(b)(4) defines premiums earned on insurance contracts during the taxable year as an amount computed as follows: From the amount of gross premiums written on insurance contracts during the taxable year deduct return premiums and premiums paid for reinsurance. To this amount add unearned premiums on outstanding business at the end of the preceding taxable year and deduct unearned premiums on outstanding business at the end of the current taxable year. Expenses such as commissions are not relevant to the computation of earned premiums. Such expenses only become relevant in the calculation of underwriting income under section 832(b)(3). See, sections 832(b)(3) and 832(b)(6). For the foregoing reasons, the numerator of the fractions described in the regulations should not be reduced by expenses.